BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No . 86R-1885-RO
BOBBY L. AND JOY C. STEPHENS	)	
	)	

For Appellants: Bobby L. and Joy C. Stephens
In pro. per.

For Respondent: John A. Stilwell, Jr.
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of 'Bobby L. and Joy C. Stephens for refund of personal income tax in the amounts of $1,400 and $1,434 for the years 1978 and 1979, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.'

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The issue presented here is whether appellants were entitled to take deductions under section 17223 of the Revenue and Taxation Code for research and experimental expenditures made in developing experimental fishing' boats.

Appellants, Bobby L. and Joy C. Stephens, filed joint personal income tax returns for years 1978, 1979, and 1980. On each of those returns, appellants claimed a business loss deduction in connection with appellants' construction of two fishing boats.

Construction began in March 1977, under an oral agreement with Robert and Gina Valladao. However, a written joint venture agreement was eventually signed on December 24, 1978. The stated purpose of the joint venture agreement was to construct the fishing boats and then, upon completion, engage in the business of commercial fishing.

About December 1979, the purpose of the joint venture changed. It was decided that the boats under construction would be developed as experimental prototype models. After the experimental boats were tested, the final marine design plans would then be marketed.

In 1982 respondent's auditor inspected the boats and concluded that, although the boats did include new and unusual features, the appellants did not incur deductible research and development expenses in connection with an existing trade or business. Therefore, the deductions were not allowable under Revenue and Taxation Code, section 17223.

As a result of the audit, the respondent issued notices of proposed assessment against the appellants for years 1978, 1979 and 1980. Upon appellants' protest, the respondent withdrew its proposed assessment for 1980 upon its review of Snow v. Commissioner, 416 U.S. 500 [40 L.Ed.2d 336] (1974). In that case, the taxpayer formed a partnership in 1966 with an inventor to develop a special purpose incinerator; (Id. at 501-502.) The court said that the research expenditures were deductible even though the taxpayer made no effort to sell the device before or during 1966. (Id. at 502-503.)

Respondent allowed the" deduction, under Revenue and Taxation Code, section 17223, for 1980 because it felt at that time there was a change in purpose of the joint venture to research and experimentation, and that the expenditures were incurred "in connection with [a] trade or business." However, the respondent affirmed its proposed assessments for years 1978 and 19.79.

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Appellants paid the tax and interest for 1978 and 1979 and filed claims for refund. After respondent denied the claims, appellants filed a timely appeal.

Deductions are a matter of legislative grace and the taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. (New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 [78 L.Ed. 13481 (1934); Appeal of James M. Denny, Cal. St. Bd. of Equal., May 17, 1962.) In this instance, appellants have failed to show that they are entitled to take the deductions under Revenue and Taxation Code, section 17223, for years 1978 and 1979.

Revenue and Taxation Code, section 17223, subdivision (a)(1), provides that a taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to the capital account. Such expenditures shall be treated as a deduction. Since Internal Revenue Code, section 174(a), is the counterpart of the state statute, cases interpreting this federal provision are persuasive authority in interpreting Revenue and Taxation Code, section 17223. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 4281 (1941).)

Appellants argue that under Snow v. Commissioner, supra, a new venture is allowed research cost deductions even though the product is not finished or marketable in the year such deductions are incurred. We find that appellants' interpretations of *Snow*, supra, is inapplicable to the facts of this appeal. The Court in Snow, supra, established only that the taxpayer need not currently produce or sell any product in order to obtain a deduction for research expenses. (Snow v. Commissioner, supra, at 502-503.) It did not eliminate the "trade or business" requirement of Internal Revenue Code, section 174, altogether. (Green v. Commissioner, 83 T.C. 667, 686 (1984).) The taxpayer must still be engaged in some trade or business during the taxable year. (Id.) If the taxpayer is not engaged in any trade or business during the appeal year he is not entitled to any deduction for research or experimental expenditures. Therefore, we must still determine whether a trade or business existed at the time the deductions were claimed. (Lahr v. Commissioner, ¶ 84,472 T.C.M. (P-H) (1984).)

Whether a taxpayer is engaged in a trade or business requires an examination of all relevant facts. (Commissioner v. Groetzinger, U.S. ___, [94 L.Ed.2d 251 (1987).) Courts have focused on three factors indicative of whether a trade or

business exists in applying the facts and circumstances test. (McManus, III v. Commissioner, ¶ 87,457 T.C.M. (P-H) (1987).)

First, the taxpayer must undertake an activity intending to make a profit. (McManus, III v. Commissioner, supra; see Drobny v. Commissioner, 86 T.C. 1326, 1340 (1986) and Green v. Commissioner, supra, at 684.) In 1978, there was, as yet, no profit motive since the record shows that the appellants intended to engage in the trade or business of commercial fishing only after the boats were completed. At sometime near year-end 1979 the appellants' purpose in the venture changed to developing an experimental commercial fishing boat for profit. The record, therefore, reflects that there was no intent to make a profit through selling commercial fishing designs before the end of 1979.

Second, the taxpayer must be regularly and actively involved in the activity. (McManus, III v. Commissioner, supra: see Commissioner v. Groetzinger, supra, 94 L.Ed.2d at 37.) In 1978 and 1979, the appellants were neither involved in commercial fishing nor marketing commercial fishing- boat designs.

Third, the taxpayer's business operations must have actually commenced. (McManus, III v. Commissioner, supra, at 87-2421.) Although appellants may have changed its business purpose to marketing commercial fishing boat designs in 1979 and expended funds toward that goal, it had not "begun to function as a going concern and [perform] those activities for which it was organized." (Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965), vacated per curiam on other grounds, 382 U.S. 68 [15 L.Ed.2d 1431 (1965).) As a commercial fishing venture, the business never commenced since no boats were ever actually engaged in commercial fishing. As a venture to market commercial fishing boat designs, the joint venture also never began business during 1978 and 1979.

Based on the foregoing; we must conclude that the appellants have not met their burden of showing entitlement to the disallowed deductions for 1978 and 1979. Accordingly, respondent's denial of appellants' claims for refund must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation code, that the actions of the Franchise Tax Board in denying the claims of Bobby L. and Joy C. Stephens for refund of personal income tax in the amounts of $1,400 and $1,434 for the years 1978 and 1979, respectively, be and the same are hereby sustained.

Done at Sacramento, California, this 3rd day of May 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Carpenter and Mr. Collis present.

Ernest J. Dronenburg, Jr., Chairman

Paul Carpenter, Member

Conway H. Collis, Member

_____, Member

_____, Member